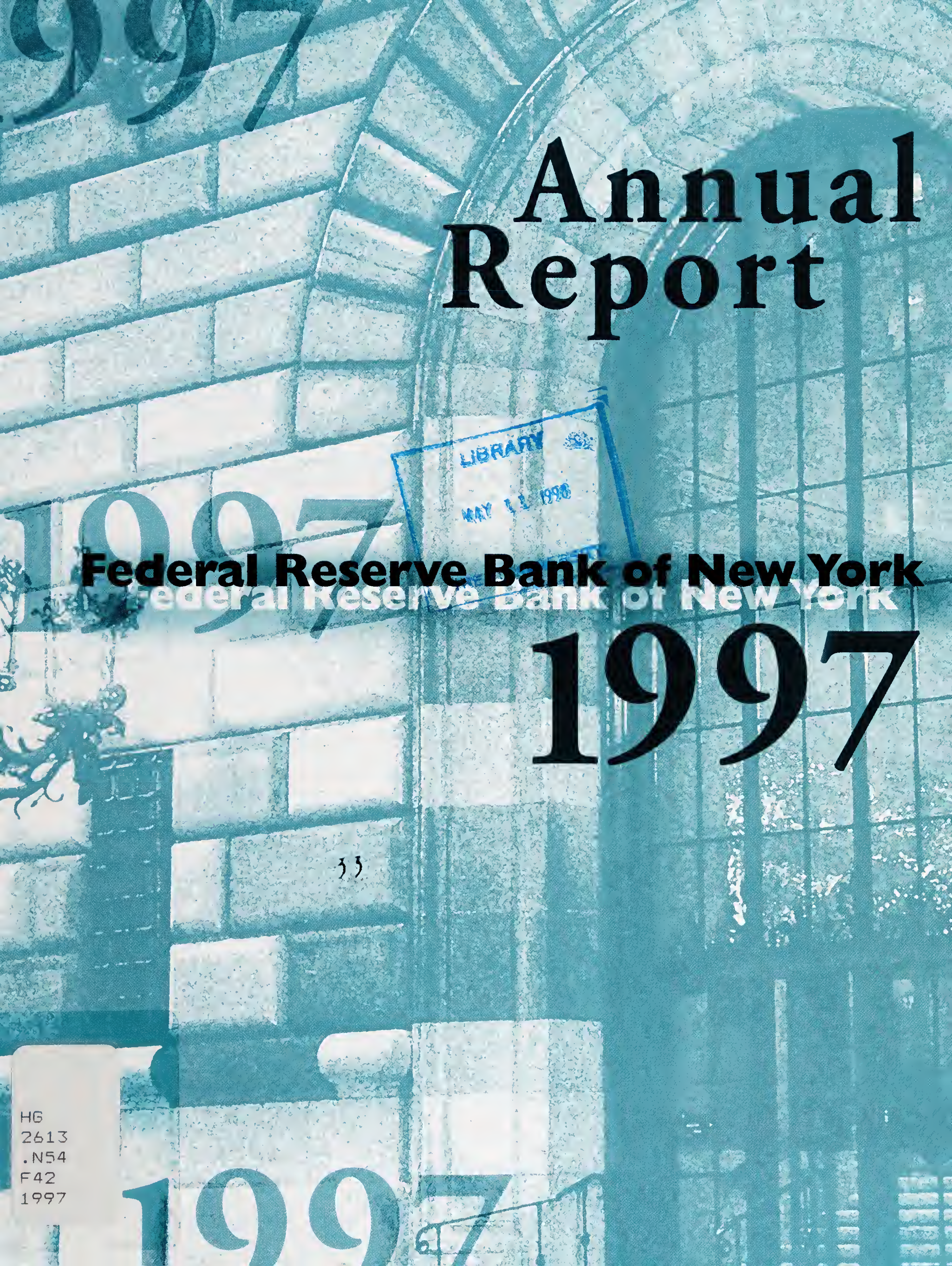

Annual Report

Federal Reserve Bank of New York

1997

Federal Reserve Bank of New York

Eighty-Third Annual Report

For the year ended December 31, 1997

SECOND FEDERAL RESERVE DISTRICT

April 1998

To the Depository Institutions in the
Second Federal Reserve District

It is my privilege to send to you the *Eighty-Third Annual Report* of the Federal Reserve Bank of New York. In the "Report from the President," I review the Bank's major accomplishments in 1997 and identify some of the critical tasks facing the Bank. In addition, the *Annual Report* presents detailed tables, with extensive notes, on the Bank's financial condition.

Several trends that are rapidly reshaping the financial services industry will present banking supervisors with major challenges in the years ahead. In 1997, I spoke publicly about those trends and the importance of effective supervision of financial institutions as a cornerstone of global stability. In "The Changing Role of Supervision," an address before the Institute of International Bankers on September 10, 1997, I proposed a detailed supervisory strategy that emphasizes prevention, draws on market discipline, and encourages cooperation between the private and public sectors. The text of the address is reprinted in this *Annual Report.*

I hope that you will find the *Annual Report* informative and interesting.

William J. McDonough

President

Contents

The Changing Role of Supervision

Remarks by
William J. McDonough
President
Federal Reserve Bank of New York

Delivered before the
Institute of International Bankers
Waldorf-Astoria Hotel
New York, New York

Wednesday, September 10, 1997

THE CHANGING ROLE OF SUPERVISION

I am delighted to speak to you today on a topic that I believe is gaining more and more attention around the globe: the supervision of financial institutions. Let me make clear at the outset that I define supervision in the broadest sense, covering official supervision as well as supervision by the marketplace itself. At the Federal Reserve Bank of New York, we have spent a lot of time thinking about the future of financial institutions supervision, and today I would like to share with you some of these thoughts.

Effective supervision of financial institutions is a cornerstone of global financial stability, and it has been raised to the top of the agenda of the last three Group of Seven summits. While it is broadly recognized that the risk of a systemic crisis emanating from problems at a financial institution or a group of institutions is relatively low, the potential cost could be very high. It is a bet none of us wants to take. We have now experienced our fair share of shots across the bow: Herstatt, Continental Illinois, Drexel, BCCI, Daiwa, and Barings. And a growing number of countries—both industrialized and developing—have paid the high macroeconomic costs of an ailing financial services industry.

How should supervision be structured to meet the next set of challenges? To answer this question, I will first discuss some of the currents that are driving the rapid changes we are witnessing in the financial services industry. Then I will review the basic objectives of supervision and present what I believe to be the most effective strategy for putting these supervisory objectives into practice.

While I will focus primarily on issues of supervision related to banks and financial conglomerates that carry out material banking activities, I believe that many of the issues are relevant for financial institutions more generally.

Effective supervision of financial institutions is a cornerstone of global financial stability.

EVOLUTION OF THE FINANCIAL SERVICES INDUSTRY

An informed discussion of how to approach supervision as we enter the twenty-first century cannot occur without a clear understanding of the major trends that have been reshaping the financial services industry for some time now. I believe that many of the dramatic and rapid changes we have witnessed over just the past ten years or so are likely not only to continue, but also to accelerate in the future. Let me highlight five:

- First, *deregulation and globalization*: The fall of the Berlin Wall has led to the opening of new markets in Eastern Europe. At the same time, countries in Asia and Latin America have lifted restrictions on capital movements and begun to deregulate their economies and financial services sectors. As a result, financial institutions from the

Some financial institutions are sure to fall by the wayside, and it is up to official supervisors to create the appropriate framework to ensure that this process unfolds in an orderly fashion.

industrialized nations have expanded rapidly into these new markets while financial institutions from emerging market economies are entering our markets.

- Second, *growing competition*: Deregulation and globalization have created new opportunities for financial institutions, but they have also intensified competition. In the United States, banks clearly are in competition with securities firms, insurance companies, mutual funds, pension funds, and finance companies, as well as hedge funds. Investors, whether retail or wholesale, face a growing range of choices about where to place their funds, and the ongoing securitization of financial assets has altered banks' classical role in the intermediation process.
- Third, *consolidation within industry sectors*: It is not surprising that growing competition has resulted and will continue to result in industry consolidation. Some financial institutions are sure to fall by the wayside, and it is up to official supervisors to create the appropriate framework to ensure that this process unfolds in an orderly fashion.
- Fourth, *the rapid growth of financial conglomerates*: One form of industry consolidation is the growing trend toward financial conglomerates, which combine banking, securities, and insurance activities in a single group. In the United States, it is only a matter of time before the final vestiges of the Glass-Steagall Act fall, and I also believe that banks' insurance activities will expand significantly in the future.
- And fifth, *innovation in products and risk management techniques*: In the past ten years, we have witnessed a revolution in financial innovation at banks and other financial services providers, both in terms of products and risk management techniques. Over the course of the 1990s, financial institutions have begun to apply modern portfolio theory to the management of their market risk, using techniques such as value at risk. The next frontier, toward which the pioneers are already en route, is to extend these techniques to the modeling of credit and operational risk—ultimately linking market, credit, and operational risk management in a single methodology. And increasingly, risks are managed on a global basis, cutting across products, countries, and legal entities.

THE CHANGING ROLE OF SUPERVISION

These developments present serious questions about how supervision should be structured in the twenty-first century. However, to begin answering these questions, we must first identify the basic objectives of supervision in this rapidly changing environment.

I believe that the reasons for official supervisory intervention in the banking system, and in the financial system more generally, can be summed up as promoting financial market stability and minimizing systemic risk. This is a

broad mandate and one that encompasses the responsibility to ensure that markets operate in a fair, transparent, and efficient manner and that participants comply with the rules of the game, in a context in which small, unsophisticated depositors and investors are protected.

While important, protecting the deposit insurance fund will not be the primary objective of supervision in the future. I believe this for two reasons: First, there is a growing realization that our approach to deposit insurance needs to be reconsidered so as to minimize the potential for moral hazard and to focus on only those small depositors that truly require protection. And second, the share of household savings in the banking system has declined dramatically.

Supervision increasingly will be about promoting financial market stability. The dramatic transformations in the financial services industry require us to be particularly vigilant to ensure that these changes proceed in an orderly fashion. We have seen numerous examples of the potential damage to the financial system, and to the real economy more generally, when deregulation and innovation are not accompanied by sufficient oversight by official supervisors and the market. In the United States, the most notable example was the savings and loan crisis.

I believe that central banks have a particularly important role to play in this regard, because ultimately they must provide liquidity and perform crisis management to ensure that problems at financial institutions (banks or nonbanks) do not take on systemic proportions and spill over into the real economy. My experience tells me that to carry out this role effectively in the United States, the Federal Reserve must have hands-on responsibility for the supervision of banks and conglomerates with material banking activities. Day-to-day involvement in supervision is the only way to detect problems early on and to prevent them from spreading to other financial institutions or to the payments system.

So what, specifically, can we do to foster this objective of financial stability? Let me state up front that I do not believe there is a quick-fix, cookie-cutter answer. The financial marketplace is too dynamic and complex, and we must work within political realities. Instead, what I would envision is a multipronged strategy that emphasizes prevention, goes with the grain of the market, and fosters cooperation between the private and public sectors.

The key elements of this strategy are

- sound capital adequacy standards,
- effective management oversight,
- market discipline, and
- a dynamic, risk-focused approach to official supervision.

Let me discuss each of these in turn, noting that each should reinforce the others to maintain a safe and sound financial system.

What I would envision is a multipronged strategy that emphasizes prevention, goes with the grain of the market, and fosters cooperation between the private and public sectors.

Capital Adequacy

Capital has played, and continues to play, an important role in the supervisory tool kit. An adequate capital cushion helps ensure that shareholders monitor the risk of financial institutions and that they put in place appropriate oversight mechanisms to help prevent problems from surfacing in the first place.

We need to begin thinking now about a comprehensive framework for the next generation of capital rules—particularly given the long lead times involved.

Should an institution experience difficulties, capital will serve as a buffer to absorb losses and reduce the risk of spillover from a problem institution to other financial institutions.

Bank supervisors' thinking on capital is evolving with the changes we are seeing in how banks manage their risk exposures. The Basle Capital Accord's market risk amendment, which will go into effect at year-end 1997, is a case in point. It represents a significant shift in capital supervision, moving away for the first time from the prevailing approach of a mandated and rigid regulatory formula or ratio. It also represents a major step toward a more market-based approach to supervision that draws on banks' internal methodologies for risk measurement, places greater emphasis on promoting sound risk management and control processes, and encourages further innovation and improvement in the banks' internal models.

While the market risk amendment represents an important step in the right direction, we need to begin thinking now about a comprehensive framework for the next generation of capital rules—particularly given the long lead times involved. As an example, the original Basle Capital Accord took about five years to develop, and almost seven more years were required to reach agreement on the market risk amendment. I believe that a review of the current capital framework needs to address at least the following questions:

- How do we reconcile the sophistication of the internal models approach used to measure market risk with the relatively simple methodology of the original Capital Accord for measuring credit risk?
- How do we explicitly incorporate into the capital framework other critical risk areas, such as portfolio concentrations and operational, liquidity, legal, and information systems risks?
- How do we ensure that the capital framework is consistent with the direction of the industry, in which financial institutions are moving toward a more integrated approach to the measurement and management of their various risk exposures—in particular, credit and market risk?
- How do we ensure that the capital framework is sufficiently broad to reflect the growing tendency of financial institutions to take on and manage banking, securities, and insurance risks by using derivatives and investment products? And is there value in studying not only volatility-based models of risk, such as value at risk, but also the models used by insurance firms to manage catastrophic risk?
- How do we address the problem of divergent accounting standards, which continue to impede comparisons of earnings, asset valuations, reserves, and capital across borders?
- And finally, how do we assess the consolidated capital position of the growing number of internationally active financial conglomerates that combine banking, securities, and insurance activities in a single group?

As you may know, the Federal Reserve System is also giving thought to the issue of capital. Not too long ago, the Federal Reserve Board put out for public comment a so-called precommitment approach.

Under the precommitment approach, regulators would no longer specify any capital adequacy ratios or other analytical measures of capital for market risk. Rather, banks would be permitted to commit capital consistent with their own estimate of their maximum trading loss exposure. However, if a bank suffered cumulative losses larger than its committed capital at any point during a particular commitment period, it would face a penalty, which could take the form of public disclosure, a higher capital requirement going forward, or even monetary fines.

The challenge of the precommitment approach is to put in place incentives that align, as much as possible, supervisors' safety and soundness concerns with an institution's incentives to measure, monitor, and dynamically manage its market risk exposures. Bank management—and not supervisors—would set the quantitative parameters of the model.

The precommitment approach does raise a number of complex issues, including, for example, the questions of how to select the desired capital levels, how those desired levels of capital relate to precommitment amounts, and how to define the penalty function. The New York Clearing House is currently conducting a pilot study with a number of major banking institutions to improve our understanding of these issues.

We at the New York Fed have also been doing some thinking about the next generation of capital requirements. Not too long ago, we published an article by Arturo Estrella, one of our senior research officers, arguing that the efforts of supervisors should focus on assessing the reasonableness of a firm's approach to setting its internal capital requirement without attempting to specify the methodology or assumptions to be used. However, the supervisor would define a minimum capital requirement that is simple, objective, and comparable across institutions and that is roughly representative of a firm's overall economic risk. It is expected that a firm's internal capital requirement would generally lie well above the supervisory minimum.

The New York Fed also plans to host a conference in February 1998 on the theme "Financial Services at the Crossroad: Capital Regulation in the Twenty-First Century." With international participation by industry members, supervisors, and academics, the conference should afford an excellent opportunity to explore innovative ideas on how we might improve the international capital framework for the twenty-first century. And I hope that such a framework would be broad enough to cover not only banks, but also financial conglomerates that may also contain securities firms and insurance companies.

Of course, all the capital in the universe will not be enough if a rogue trader or loan officer is able to operate recklessly or fraudulently in an environment lacking sound internal controls and proper risk management systems. Thus, while a sound capital adequacy

While a sound capital adequacy framework is essential to financial market stability, it must be complemented by effective management at the firm level, by market discipline, and by meaningful official supervision.

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framework is essential to financial market stability, it must be complemented by effective management at the firm level, by market discipline, and by meaningful official supervision.

Management Oversight

This leads me to my next point: The primary responsibility for the safe and sound operation of an institution lies with its board of directors and senior management. Effective management supervision is the first and most important line of defense against potential problems, and this will increasingly be the case as the activities of financial services institutions become more global and complex.

Overall, I believe the industry has made significant progress in recent years in strengthening risk management capabilities and practices. And the supervisory community remains committed to working with the industry to do even more to improve those risk management practices over the period ahead.

That being said, I continue to be surprised by the persistence of significant losses at major global institutions that can be traced to basic, avoidable breakdowns in management controls. It is even more surprising considering that the principles of sound risk management and controls have been promulgated and published globally, by the Basle Committee on Banking Supervision and the Group of Thirty among others, and, in principle, have been fully embraced by the industry.

How can this phenomenon be explained? Although part of the answer may just be bad luck, I believe that a more important explanation lies in what I would term "culture issues." While on paper it may appear that an institution has put in place a risk management and control structure, this structure may not be accompanied by the institutional management culture needed to ensure that written policies and procedures are actually translated into practice, with buy-in at all staff levels. They all need to be in sync.

Ultimately, an institution's culture is set by the board of directors and the quality of senior management it chooses to install. If the board of directors and senior management are interested excessively in profits and choose to pretend that profits do not involve risk, the institution is in grave peril. Senior management, assuming it has its own values straight, must ensure that the right tone filters down the line of the organization. However, culture has to do with the most basic values that individuals and groups embrace, so it is fairly inertial and slow to change. This inertia is a big advantage if you have the right culture, and it is a big risk to your business if you do not. Symptoms of a culture that is not conducive to prudent business practices include the following:

- Poor communication, including the failure to encourage individuals to deal promptly with problems and to alert management early on. This may also include poor communication of material events to supervisors, an issue we have raised with our supervised institutions over the past year or so.
- Rewarding officers for business profitability through promotion or compensation when there are many control

deficiencies in that business that remain outstanding for long periods of time.

- An inappropriate balance in the importance of business lines, audit, and control functions. This lack of balance may manifest itself through reporting lines and compensation policies.
- Hiring practices that do not adequately screen potential employees for a track record of integrity. I believe that this is one of the best, but least acknowledged, ways to nip fraud in the bud—namely, right at the entrance door.
- Aggressive recruiting that entails offering salaries far above the market norm (with the resultant pressure to take on excessive risks).
- Aggressive performance-based compensation packages that do not account for risks at the inception of a deal.
- A failure to question the source and sustainability of profits that are excessive in relation to the riskiness of a given activity.

A concrete and timely example of the importance of senior management's proactive stance in the risk management and control process is the year 2000 issue. The Federal Reserve has emphasized that responsibility for preparing for this event rests squarely with the senior management of banks—and we expect them to be on top of the issue. I anticipate that variations in how institutions deal with this issue will be highly correlated with the quality of their management, the quality of their controls, and the strength of their corporate culture.

Market Discipline

After effective management supervision, the second line of defense against financial instability takes the form of market discipline. As financial institutions and their activities become more complex, diversified, and global in nature, I believe that market discipline will become an even more important ally of the supervisor than it is now.

Effective market discipline is not possible without meaningful public disclosures. Unfortunately, disclosure practices have not kept pace with the rapid changes in banks' business activities and risk exposures, and with how these exposures are measured and managed. Recent initiatives by the industry, the Group of Thirty, the Group of Ten central banks, and the Basle Committee on Banking Supervision have focused on improving disclosure of trading and derivatives exposures of both banks and securities firms, and I note that the industry has made significant progress in this area. But more work can and should be done.

For example, many countries still need to improve the quality of their disclosures for traditional lending activities. Time and again experience has shown that in periods of stress, insufficient information about asset quality can lead to rumors and overreactions in the marketplace, creating the potential for problems to spread to institutions that may otherwise be in relatively good health.

Effective market discipline is not possible without meaningful public disclosures.

While management oversight and market discipline are crucial elements of a strategy to promote financial stability, neither can substitute for the critical role played by official supervision.

A more difficult and fundamental issue is how far management discussions in financial statements can go toward revealing the true quality of internal controls and global risk management systems of large, complex financial institutions. Currently, there are no common criteria for measuring and disclosing such information. Market participants are left to rely on regulators or diverse opinions of external auditors to ascertain the quality of management controls. In this context, the Group of Thirty recently issued an interesting proposal that, among other things, calls for the development of an international industry framework for comprehensive and effective management controls. This framework would be validated through a groupwide global audit, and the results would be disclosed to the public. The G-30 initiative represents an important step in the right direction. But, as the G-30 itself points out, such an initiative can only bear fruit if the private sector and the supervisory community collaborate closely.

Progress on the disclosure front will be limited if accounting standards are not enhanced to reflect innovations over the past ten years, both in terms of new products and modern risk management techniques. And there is a need for greater harmonization of accounting standards across countries. An important first step would be to improve our understanding of the major differences that exist in national accounting conventions. We simply must get to the point where supervisors and market participants alike can compare all global financial institutions on a consistent basis. And it will not be possible to have uniform capital standards until we have achieved a minimum degree of consistency in accounting standards across countries.

Official Supervision

While management oversight and market discipline are crucial elements of a strategy to promote financial stability, neither can substitute for the critical role played by official supervision. Official supervisors have a number of comparative advantages that they can bring to the table:

- First, supervisors have clear incentives to monitor risks to the financial system as a whole. While each financial institution is best positioned to monitor its own risk exposure, it does not have the incentives to internalize the costs it may impose on other financial institutions should it experience difficulties.
- Second, supervisors are able to obtain and monitor proprietary information about an institution's risk exposures, its management information systems, and its internal controls when such information does not lend itself to public disclosures.
- Third, supervisors are in a unique position to observe trends across groups of financial institutions and, on the basis of these insights, to provide the industry with a perspective on what constitutes sound practice.

For example, the New York Fed conducted a comprehensive review of private banking activities at about forty domestic and foreign banking

organizations in the Second District. Using New York's findings, the Federal Reserve recently released a sound practices paper that contains guidance on basic controls to minimize reputational and legal risk and to deter illicit activities such as money laundering.

- Fourth, official supervision is needed to enforce compliance with applicable laws and regulations. We have observed that poor compliance, in addition to simply being wrong, can result in serious reputational risk. In certain cases, a problem in this area could threaten the well-being of a financial institution.

- Finally, supervisors are able to ensure that prompt corrective actions are taken when serious financial or other problems are identified, particularly if the problems are not known to the market. The critical role that can be played by the supervisor in problem cases, both through public enforcement actions and through other, less visible means, cannot be overstated.

Changes in the financial services industry present new challenges for how official supervision is to be carried out most effectively. Let me just mention a few:

- The scope of supervision needs to evolve in line with the way financial institutions manage their activities, which increasingly is on a global portfolio basis and no longer along legal entity lines.

- We need to continue our efforts to develop a more dynamic, process-oriented, and risk-focused supervisory framework, reflecting the reality that financial institutions are able to alter their risk profile at will. By "process-oriented," I mean that examiners and/or auditors should ascertain whether the risk management process and the risk control environment of the organization as a whole are adequate given the nature of its business. By "risk-focused," I mean that resources should be directed at the most material risks to which the institution is exposed. Institutions that demonstrate a sound risk management and control structure and environment should be subject to less intrusive supervision than institutions that do not have this essential infrastructure in place.

- We, the supervisors, need to sustain our efforts to ensure that we have in place state-of-the-art information technologies and that we train our staff to keep pace with the growing complexity of financial institutions' operations. In this regard, it is often said that supervisors cannot attract and retain staff with the technical expertise necessary to understand the high-tech instruments and models at financial institutions. I believe this view is wrong. For example, at the New York Fed we have always been able to hire and retain a critical mass of top-level individuals by focusing challenges and new responsibilities on

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Most important, supervisors need to come up with a contemporary model for overseeing the activities of financial conglomerates.

those people with a strong interest in shaping public policy.

- But the qualifications and training of our examiners should reflect the reality that the global financial business today is an information technology business, based on financial theory of increasing rigor and precision and on sophisticated operational analysis. This means that we must not only train specialists with well-developed expertise, and in the right areas, but also attain synergies among the different specialists through, for example, the use of multidisciplinary teams that can review whole business lines.

Most important, supervisors need to come up with a contemporary model for overseeing the activities of financial conglomerates. It has become increasingly difficult for supervisors and the industry to distinguish the business of banks from the business of securities firms. As the Barings incident and other major financial problems have shown, the linkages among global banks and securities firms are far greater and more extensive than just their direct, measured credit exposures. Additional exposures include funding relationships, membership in clearinghouses and exchanges, securities clearing operations, and fiduciary businesses. Given these linkages, the failure of either a major bank or a securities firm could have broad systemic effects on the financial system. This leads me to conclude that all global financial conglomerates large enough to pose a potential threat to the stability of the financial system should, at minimum, be subject to some form of consolidated supervisory oversight that has market stability as its guiding principle. Such a limited supervisory framework might include the following key elements:

- Designation of an "umbrella" supervisor to provide consolidated oversight and to facilitate the sharing of information across the group's various national and functional supervisors. It is also time to determine definitively what legal impediments to information flows actually exist and to set them aside fully.

- Agreed-upon channels of communication among home- and host-country supervisors, and the willingness to raise supervisory concerns and to hear them.

- Adequate direct reporting of information to the umbrella supervisor by the conglomerate itself, to the extent that existing information flows must be supplemented for a representative view of the enterprise.

- Some framework for assessing capital adequacy on a consolidated basis. Such a framework needs to be sufficiently flexible to cover not only exposures related to the banking and securities businesses, but also insurance underwriting risks. I believe that we should look to a framework that draws on the best practices developed by all three of these industry sectors and their functional supervisors.

- Qualitative standards for the management of interaffiliate exposures, perhaps supplemented by quantitative limits.
- Periodic coordinated reviews of the conglomerate's risk management and internal control systems, including efforts to ensure compliance with applicable laws and regulations and to ensure the identification of concentrations.

In the current debate on the appropriate supervisory framework for financial conglomerates, a distinction is made between those conglomerates with a significant proportion of business concentrated in banking activities and those that engage primarily in nonbank financial activities. The former group requires a higher degree of supervisory oversight to protect banks from activities conducted in nonbank affiliates. However, as the activities of "banks" change—with assets becoming more and more liquid and reliance on insured deposits decreasing—it becomes necessary for supervisors to consider a more uniform approach to all large financial conglomerates. This brings me back to where I started, namely that the future of supervision will be about ensuring the stability of all financial institutions—whether they belong to a single industry or are conglomerates—that have the potential to destabilize the financial system.

CONCLUSION

I recognize that I have outlined an ambitious agenda for the supervision of financial institutions that will carry us into the twenty-first century. In implementing this agenda, we must recognize that the public and private sectors each have an important role to play. Indeed, only if the two work together and reinforce each other do I believe that we will be able to supervise effectively the rapidly evolving financial services industry going forward. We have seen a growing number of examples in which this collaboration has worked well, including the area of public disclosure, efforts to develop capital requirements for market risk, and the initiatives of the Bank for International Settlements' Committee on Payment and Settlement Systems to promote private sector solutions that will result in the elimination of foreign exchange settlement risk. If such cooperation is done right, it can make a significant contribution to achieving a safer and sounder financial system.

Thank you.

Report from the President

REPORT FROM THE PRESIDENT

Every year presents new challenges for the Bank, and 1997 was no exception. I believe the Bank performed exceptionally well in meeting those challenges, particularly in fulfilling its most important responsibility, the implementation of monetary policy. By most measures, the economy's performance in 1997—with declining inflation, low unemployment, and steady job and output growth—was its best in several decades. Over the course of the year, short-term interest rates remained stable and long-term rates declined. This favorable economic and financial environment helped to strengthen business investment, the housing sector, and sales of big-ticket items; strength in these sectors, in turn, contributed significantly to improved fiscal conditions and a buoyant stock market.

The Bank engages in a broad range of market surveillance and information-gathering activities as part of its policy responsibilities. These efforts are designed to keep Federal Reserve policymakers up to date about developments in financial markets, banking, emerging markets, and the regional economy. In the latter part of 1997, a major focus of the Bank's market surveillance efforts was the monitoring and assessment of the evolving financial situation in Asia and its potential impact on domestic and foreign markets and institutions. Bank staff provided valuable support to policymakers, including extensive analyses of developments in Thailand, Indonesia, Korea, and other countries.

Toward year-end, as the full dimensions of Korea's financial problems were beginning to become clear, a consensus emerged that an international program of support—from both the private and the public sectors—would be required to address the immediate liquidity problems of Korea's banks, thereby providing Korea with needed time to resolve its structural problems. To further this goal, the Bank organized several meetings in December with leading investment firms, commercial banks, and public sector officials to help lay the groundwork for governmental and private sector actions. Since then, we have directed our efforts toward helping to reestablish and maintain financial stability in Korea. These efforts, and several other initiatives during the year involving bank supervision, monetary policy implementation, and the rapid evolution of the payments system, were evidence of the continued leadership of this Bank in crucial central banking issues.

I am particularly proud of the research, analysis, and operational support that the Bank's staff provided in meeting both the domestic and the international challenges of 1997. This work demonstrated once again the knowledge, professional skill, and dedication to public service of the men and women who work at the Bank.

I am particularly proud of the research, analysis, and operational support that the Bank's staff provided in meeting both the domestic and the international challenges of 1997.

During the year, the Bank continued to broaden its role as a facilitator of discussion and analysis of important public policy issues by convening major conferences and colloquia.

CONTRIBUTING TO THE PUBLIC POLICY DEBATE

A major goal we established for the Bank at the beginning of the year was to expand the contribution of Bank research to the public's understanding of issues affecting the regional, national, and global economies. This research made a difference in 1997. We produced more than 100 articles and papers and delivered nearly 600 speeches and presentations to outside groups on a truly impressive range of issues.

The Bank also contributed to an improved understanding of compelling urban economic matters. We held a conference in New Jersey on affordable housing, conducted training sessions in upstate New York communities on how to interpret Community Reinvestment Act data, and provided a number of public forums for the discussion of urban reinvestment issues. We also produced comprehensive reports profiling the distribution of affordable housing loans in Westchester County, New York, and in Bergen County, New Jersey.

During the year, the Bank continued to broaden its role as a facilitator of discussion and analysis of important public policy issues by convening major conferences and colloquia. A highlight of these activities was the November conference "Excellence in Education: Views on Improving American Education," which brought together top academic researchers in education and members of the education community to explore strategies for improving the quality of public school education. In support of that theme, I spoke before numerous audiences in 1997 to encourage businesses, government, and educational establishments to take leadership roles in integrating new technologies into school curricula and operations, with the aim of transforming schools into modern establishments of learning, skill development, and critical thinking. Promoting public discussion of this critical issue will be a continuing goal of this Bank in the years to come.

Our staff also played a prominent part in the development of key international supervisory policies. Staff provided considerable support to the efforts of the Basle Committee on Banking Supervision on a wide range of banking issues and to efforts by the G-10 Committee on Payment and Settlement Systems to understand potential risks in the global payments system.

In June, the Bank hosted a conference addressing legal issues raised by the European Monetary Union, scheduled to take place on January 1, 1999. The conference, which was attended by nearly 300 lawyers, bankers, and other interested parties, fostered a frank discussion of the many challenges and opportunities that the introduction of the new European currency, the Euro, will pose for U.S. banks.

ASSISTING FOREIGN CENTRAL BANKS AND INTERNATIONAL ORGANIZATIONS

The Bank maintains extensive relations with foreign central banks and governments. These have included, since 1916, gold storage services that have made the New York Fed the largest known depository of monetary gold in the world.

During the year, the public showed increasing interest in the disposition of Nazi gold assets, particularly gold that might have belonged to Holocaust victims. The issue is an important one for the Bank, which holds about $23 million worth of gold for the Tripartite Gold Commission (TGC). The TGC was formed after World War II to receive and distribute gold recovered by the Allies from the Nazis; this gold was believed to be monetary gold belonging to countries invaded by the Nazis. I decided early on that we should make full public disclosure of the Bank's gold records and institute a comprehensive search of the Bank's files. In carrying out this goal, we sent thousands of pages of documents to the National Archives. We also helped prepare parts of the U.S. government report on this complex issue.

Another aspect of our relations with foreign central banks involves technical assistance. We provided assistance to banking supervisors in a number of countries during the year and hosted numerous visits from foreign regulatory officials and market risk specialists. We also worked with foreign central banks to focus international attention on the need to reduce risk in global payment and settlement systems. Bank staff made many presentations on this issue in central bank forums and conferences around the world.

ENSURING A SAFE AND SOUND FINANCIAL SYSTEM

Ensuring stability in domestic and international financial markets and promoting the smooth functioning of the global payments system are ongoing challenges, and I believe the Bank performed exceedingly well in meeting them in 1997. During the year, we strengthened lines of communication and relationships with supervisors from foreign countries. Our efforts included active participation in the development of core principles for supervising global banks and for sharing information among national supervisory authorities. We also helped to develop market risk capital standards and the regulatory approach to evaluating specific risk models that formed the basis of an amendment to the Basle Capital Accord. Looking to the future, Bank staff identified a range of issues for consideration in establishing twenty-first-century capital standards for financial institutions. Early in 1998, we hosted a conference with distinguished speakers from around the world that contributed to the progress being made on this issue.

During the year, Bank staff developed a set of supervisory policies and procedures to guide banks as they adjust their automated systems to deal with the century date change—that is, correct posting of entries starting on January 1, 2000. At the same time, Bank staff worked diligently to prepare all of the Bank's computers and systems for the century date change.

We also helped develop a new rating system for trust activities and wrote a "sound practices" paper for private banking. This paper established a standard for private banking operations and provided a framework for the development of formal "know-your-customer" banking rules and new Federal Reserve procedures for examining private banking activities.

We strengthened lines of communication and relationships with supervisors from foreign countries.

[The] Bank introduced a new electronic funds transfer format and expanded funds transfer operations to eighteen hours a day.

Progress was also made in 1997 on the multiyear effort to shift the focus of the Bank's examinations of depository institutions from balance-sheet reviews to assessment of the strengths and weaknesses of internal controls, procedures, and systems banks have in place for managing risk. To this end, the Bank reorganized its bank supervision and regulation area, establishing a number of specialty teams to focus on current risks within the banking industry. In addition, the Bank helped develop new guidelines for examiners in evaluating banks' risk controls and procedures.

PROVIDING SECURE AND RELIABLE PAYMENTS SERVICES

The challenge of maintaining effective oversight of banking activities was heightened in 1997 by a historic change in the federal regulation of banks. A 1994 federal law authorizing banks to operate branches across state lines finally took effect in July. To implement interstate branching, the Federal Reserve decided that a depository institution needs to have an account with only one Reserve Bank, regardless of the number of branches and states in which the institution does business. To bring this regulatory change about, the Bank's legal staff worked with Federal Reserve System colleagues to rewrite virtually all of the contractual terms and conditions under which Reserve Banks make loans and provide banking services. The Systemwide changes in interstate banking regulations helped to position the Federal Reserve to be more responsive to banks as these institutions pursue business opportunities over broader geographic areas.

The Bank has a unique role in the nation's payments system. We not only serve as the Federal Reserve's operating arm in the government securities and foreign exchange markets, but we also provide a large share of the electronic funds transfer, book-entry securities transfer, and settlement services that commercial banks and the U.S. Treasury rely on each day.

During the year, we transferred most of our automated payments systems and applications to the Federal Reserve's centralized processing facility at the East Rutherford Operations Center (EROC) in New Jersey. This transfer was the last part of the Federal Reserve's transition to mainframe computer consolidation. At the same time, as the developer of the Fedwire software application for the Federal Reserve Banks, this Bank introduced a new electronic funds transfer format and expanded funds transfer operations to eighteen hours a day. The extended operating hours provide opportunities to reduce settlement risk, particularly in foreign exchange markets, by creating overlapping operating hours among major financial centers. In addition, we worked closely with the Treasury Department to issue the federal government's new inflation-indexed security and to provide the Treasury with improved automated systems for conducting dealer auctions and processing government securities sales.

In 1997, the U.S. monetary authorities continued the issuance of redesigned currency with the release of a new $50 banknote. As the principal international currency distribution center, this Bank took the lead in distributing

the new notes overseas, as we did in 1996 with the new $100 banknote. Among the actions we took on that occasion to ensure smooth distribution of the new notes abroad was the creation, in conjunction with the private sector, of several distribution facilities that would provide a ready supply of new notes in Europe. In 1997, we expanded our distribution program in Europe and initiated a study to determine the feasibility of establishing similar facilities in Southeast Asia.

The Bank is responsible for the management of the Federal Reserve System's Wholesale Payments Product Office, which coordinates efforts throughout the System to maintain the Federal Reserve's funds transfer and book-entry systems as the nation's premier large-value payment mechanisms. In 1997, the Product Office, which is headed by the Bank's First Vice President, Ernest Patrikis, worked with leading participants in the funds and securities markets to develop a coordinated approach to century date change testing and to establish a new, uniform settlement service nationwide.

A high priority in the financial services area in 1997 was to follow through on aggressive multiyear initiatives aimed at reorganizing work processes to improve operating efficiency and reduce the unit cost of our payments services. Although we made headway in cash, fiscal, and electronic payments services, we ran into unanticipated problems in the check area. The 1996 closing of our Jericho office and the consolidation of our downstate check-processing operations at EROC presented us with significant operational challenges. We are moving aggressively to improve check operations, with a particular focus on achieving high quality and efficiency.

STRENGTHENING INTERNAL OPERATING EFFICIENCY

During the year, Bank staff at all levels continued to work toward improved efficiency in all Bank operations and services through reengineering and restructuring. Reengineering, as we apply the concept at the Bank, involves not only structural change, but also a change in the mind-set of our managers—a presumption that all of the Bank's operations can be carried out more effectively and at lower cost.

With the help of an outside consulting firm, we put every aspect of our check operations under a microscope to determine how each process could be improved. We also instituted changes in the cash and fiscal areas, where work flows were rearranged and automated, and in the markets area, where we consolidated our foreign and domestic trading desks and began overhauling our trading and back office systems. I am particularly pleased that our reengineering efforts and investment in technology helped to lower the Bank's administrative support and overhead costs in 1997 as a percent of total Bank expenses.

In 1997, we also made progress on an effort to move paper-based data reporting and internal information distribution to electronics. A software application for electronic data submissions using Internet technology was developed during the year and piloted successfully.

During the year, Bank staff at all levels continued to work toward improved efficiency in all Bank operations and services through reengineering and restructuring.

We also instituted a change in the way we look at our internal controls and the oversight of the Bank.

The Bank will be the central site for the Systemwide development of this application in 1998. We also created an Intranet with numerous special-purpose sites and sites for areas throughout the Bank, and developed Internet sites for the Federal Reserve's Payments Systems Risk Committee and the Wholesale Payments Product Office.

We further positioned the Bank for productivity gains over the years ahead by reaching a milestone in the Bank's long-term space strategy. A twenty-five-year lease was signed for the top thirteen floors of 33 Maiden Lane, a building adjacent to 59 Maiden Lane, where the Bank currently leases space. After renovations are completed, staff currently working at 59 Maiden Lane will begin moving to the neighboring building. The move will allow us to provide staff with more modern quarters and to provide the Bank with better conference, training, and meeting rooms.

The challenge of improving operational efficiency throughout the Federal Reserve System helped bring about the establishment of the Rivlin Committee in 1996. In 1997, this committee—of which I am a member—undertook to review the Federal Reserve's role in the payments system. Bank staff were instrumental in preparing the report that summarized the Committee's review. The report concluded that the Federal Reserve should maintain a major role in the nation's check collection and automated clearinghouse systems while working collaboratively with private sector organizations to promote more efficient electronic modes of payment and settlement. We reached this conclusion after holding a series of nationwide meetings, hearings, and forums with bankers, vendors, and other major participants in the nation's retail payments system to make certain we took into consideration the concerns of all those involved.

THE CHALLENGE OF MANAGING CHANGE

To cope with developments in banking and financial markets, we have had to take a hard look at how the Bank performs, how staff is managed, and how the Bank deals with change. To meet this challenge more effectively, I began a "core values" project last year aimed at improving the overall management of the Bank. In its initial stages, this project has involved peer review assessments of how the Bank's senior managers handle their interactions with one another and with the officers and staff who work with them. I believe that the initiatives that flow from our work on core values will enable the Bank to operate even more effectively and efficiently in the years to come.

We also instituted a change in the way we look at our internal controls and the oversight of the Bank. In August, the presidents of all of the Reserve Banks voted to adopt a new, rigorous, internationally recognized framework for evaluating and managing internal controls. The framework, established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is designed to ensure that an organization's financial reports are accurate and reliable, that internal operations are conducted effectively and efficiently, and that internal operations comply with applicable laws and regulations. Shortly after this vote,

and in support of the Systemwide initiative scheduled to commence in 1998, I committed this Bank to apply the COSO framework immediately to the preparation of the Bank's year-end financial statements. A team of senior officers was established to oversee this effort, which required a methodical assessment of risks and a detailed evaluation of the strengths and weaknesses of the Bank's financial control systems.

The assertion of compliance with COSO's demanding criteria for financial reporting that appears in this *Annual Report* represents the successful outcome of our implementation effort. I am pleased that the Bank was able to take a leadership position in implementing this framework for financial reporting integrity.

PROMOTING BETTER UNDERSTANDING OF MONEY, BANKING, AND FINANCIAL ISSUES

We made a commitment in 1997 to expand our economic education programs, with an emphasis on giving students and teachers more opportunities to learn interactively about economics, finance, and monetary policy. One of these programs, The Fed Challenge, was extended to more than 150 schools in four Federal Reserve Districts and culminated in an interdistrict competition at the Board of Governors. Another program, the Econ Explorers Club, was introduced in approximately 200 elementary and middle school classes in New York and New Jersey and will be extended to hundreds of additional classes in 1998. Bank staff took part in a variety of school-to-career programs intended to ease students' transition into the workplace.

Hundreds of teachers, principals, assistant principals, and academic administrators participated in the Bank's workshops and seminars in 1997. A new "Partners for Leadership" management training program for New York City school principals was started during the year. We processed orders for more than 2.4 million Bank publications, opened an interactive educational exhibit about money and the Federal Reserve in our main lobby, and improved and expanded the Bank's web pages. We also introduced a regional economy website for those interested in monitoring Second District economic trends.

POSITIONING FOR THE CHALLENGES AHEAD

In the year ahead, a major priority for us in the bank supervision area will be the full implementation of the risk-focused examination process. To ensure success in this effort, management will give substantial attention not only to the effective planning and consistent application of the approach across banking organizations, but also to the development and retention of the high-quality staff required by this new approach. A quality assurance program was established in 1997 to monitor progress in implementing the risk-focused examination approach uniformly, and banks are now being interviewed about their experience with these exams to determine how the process might be improved further.

The financial services areas will face continued pressure to do more with fewer resources. The reduction of overhead and support costs will be a prime objective as we try to improve operating efficiency and reduce unit

In the year ahead, a major priority for us in the bank supervision area will be the full implementation of the risk-focused examination process.

costs. I believe, for example, that our check area is much better positioned to meet these challenges today than it was a year ago, largely because of its 1997 efforts to implement a methodology for generating continuous improvement. Similarly, we face an ongoing need to structure organizational arrangements and work processes to increase productivity and cost efficiency. In the international arena, perhaps our biggest challenge will be to stay on top of developments around the world and work effectively with policymakers and market participants to improve the prospects for global financial and economic stability.

I am confident that the Bank's management team, supported by the Bank's staff, will meet these challenges with great skill and resourcefulness.

January 9, 1998

To the Board of Directors of the
Federal Reserve Bank of New York:

The management of the Federal Reserve Bank of New York (FRBNY) is responsible for the preparation and fair presentation of the Statement of Financial Condition, Statement of Income, and Statement of Changes in Capital as of December 31, 1997 (the "Financial Statements"). The Financial Statements have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System and as set forth in the Financial Accounting Manual for the Federal Reserve Banks, and as such, include amounts, some of which are based on judgments and estimates of management.

The management of the FRBNY is responsible for maintaining effective internal controls over financial reporting and the safeguarding of assets as they relate to the Financial Statements. Such internal controls are designed to provide reasonable assurance to management and to the Board of Directors regarding the preparation of reliable Financial Statements. These internal controls contain self-monitoring mechanisms, including, but not limited to, divisions of responsibility and a code of conduct. Once identified, any material deficiencies in internal controls are reported to management, and appropriate corrective measures are implemented.

Even effective internal controls, no matter how well designed, have inherent limitations—including the possibility of human error and costs versus benefits considerations—and therefore can provide only reasonable assurance with respect to the preparation of reliable Financial Statements.

The management of the FRBNY assessed its internal controls over financial reporting and the safeguarding of assets reflected in the Financial Statements, based upon the criteria established in the "Internal Control—Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, the management of the FRBNY believes that the FRBNY maintained effective internal controls over financial reporting and the safeguarding of assets as they relate to the Financial Statements.

President
Federal Reserve Bank of New York

Ernest T. Patrikis
First Vice President
Federal Reserve Bank of New York

Report of Independent Accountants
Coopers & Lybrand L.L.P.

To the Board of Directors of the
Federal Reserve Bank of New York:

We have examined management's assertion that the Federal Reserve Bank of New York (the "Reserve Bank") maintained an effective internal control structure over financial reporting and over the safeguarding of assets as they relate to the Financial Statements as of December 31, 1997, included in the accompanying Management's Assertion.

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, testing, and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control structure over financial reporting to future periods are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion that the Reserve Bank maintained an effective internal control structure over financial reporting and over the safeguarding of assets as they relate to the Financial Statements as of December 31, 1997, is fairly stated, in all material respects, based upon criteria established in "Internal Control—Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Coopers & Lybrand L.L.P.

New York, New York
February 20, 1998

Financial Statements

Report of Independent Accountants
Coopers & Lybrand L.L.P.

To the Board of Governors of
the Federal Reserve System
and the Board of Directors of
the Federal Reserve Bank of New York:

We have audited the accompanying statement of condition of the Federal Reserve Bank of New York (the "Bank") as of December 31, 1997 and 1996, and the related statements of income and changes in capital for the years then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on the financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurances about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in note 3, the financial statements were prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System. These principles, policies, and practices, which were designed to meet the specialized accounting and reporting needs of the Federal Reserve System, are set forth in the Financial Accounting Manual for Federal Reserve Banks and constitute a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Bank as of December 31, 1997 and 1996, and results of its operations for the years then ended, on the basis of accounting described in note 3.

Coopers & Lybrand L.L.P.

New York, New York
March 20, 1998

STATEMENT OF CONDITION
(in millions)

ASSETS	December 31, 1997	December 31, 1996
Gold certificates	$ 3,934	$ 4,049
Special drawing rights certificates	3,202	3,385
Coin	20	21
Items in process of collection	1,026	1,796
Loans to depository institutions	1,465	—
U.S. government and federal agency securities, net	164,932	169,238
Investments denominated in foreign currencies	3,885	5,128
Accrued interest receivable	1,609	1,657
Interdistrict settlement account	16,310	—
Bank premises and equipment, net	241	233
Other assets	1,246	976
Total assets	$197,870	$186,483

LIABILITIES AND CAPITAL		
Liabilities:		
Federal Reserve notes outstanding, net	$179,316	$139,364
Deposits:		
Depository institutions	9,257	8,167
U.S. Treasury, general account	5,444	7,742
Other deposits	452	177
Deferred credit items	794	883
Statutory surplus transfer due U.S. Treasury	254	296
Interdistrict settlement account	—	27,599
Accrued benefit cost	144	136
Other liabilities	45	43
Total liabilities	195,706	184,407
Capital:		
Capital paid-in	1,108	1,052
Surplus	1,056	1,024
Total capital	2,164	2,076
Total liabilities and capital	$197,870	$186,483

The accompanying notes are an integral part of these financial statements.

STATEMENT OF INCOME

for the years ended December 31, 1997, and December 31, 1996
(in millions)

	December 31, 1997	December 31, 1996
Interest income:		
Interest on U.S. government securities	$9,014	$9,207
Interest on foreign currencies	86	118
Interest on loans to depository institutions	2	1
Total interest income	**9,102**	**9,326**
Other operating income (loss):		
Income from services	98	105
Reimbursable services to government agencies	47	45
Foreign currency (losses), net	(591)	(444)
Government securities gains, net	4	12
Other income	30	32
Total other operating income (loss)	(412)	(250)
Operating expenses:		
Salaries and other benefits	285	284
Occupancy expense	43	43
Equipment expense	39	37
Cost of unreimbursed Treasury services	2	4
Assessments by Board of Governors	158	183
Other expenses	134	116
Total operating expenses	661	667
Net income before net periodic pension expense	8,029	8,409
Net periodic pension credit	(201)	(141)
Net income prior to distribution	$8,230	$8,550
Distribution of net income:		
Dividends paid to member banks	65	65
Transferred to (from) surplus	56	(5)
Payments to U.S. Treasury as interest on Federal Reserve notes	—	6,119
Payments to U.S. Treasury as required by statute	8,109	2,371
Total distribution	$8,230	$8,550

The accompanying notes are an integral part of these financial statements.

STATEMENT OF CHANGES IN CAPITAL

for the years ended December 31, 1997, and December 31, 1996
(in millions)

	Capital Paid-in	Surplus	Total Capital
Balance at January 1, 1996 (21.1 million shares)	**$1,057**	**$1,057**	**$2,114**
Net income transferred to (from) surplus	—	(5)	(5)
Statutory surplus transfer to the U.S. Treasury	—	(28)	(28)
Net change in capital stock issued (redeemed) (0.1 million shares)	$ (5)	—	$ (5)
Balance at December 31, 1996 (21.0 million shares)	**$1,052**	**$1,024**	**$2,076**
Net income transferred to (from) surplus	—	56	56
Statutory surplus transfer to the U.S. Treasury	—	(24)	(24)
Net change in capital stock issued (redeemed) (1.2 million shares)	$ 56	—	$ 56
Balance at December 31, 1997 (22.2 million shares)	**$1,108**	**$1,056**	**$2,164**

The accompanying notes are an integral part of these financial statements.

FEDERAL RESERVE BANK OF NEW YORK
Notes to Financial Statements

1. ORGANIZATION

The Federal Reserve Bank of New York ("Bank") is part of the Federal Reserve System ("System") created by Congress under the Federal Reserve Act of 1913 ("Federal Reserve Act"), which established the central bank of the United States. The System consists of the Board of Governors of the Federal Reserve System ("Board of Governors") and twelve Federal Reserve Banks ("Reserve Banks"). The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. Other major elements of the System are the Federal Open Market Committee ("FOMC") and the Federal Advisory Council. The FOMC is composed of members of the Board of Governors, this Bank's president, and, on a rotating basis, four other Reserve Bank presidents.

Structure

The Bank and its branch in Buffalo serve the Second Federal Reserve District, which includes the state of New York, the twelve northern counties of New Jersey, and Fairfield County, Connecticut, as well as the Commonwealth of Puerto Rico and the U.S. Virgin Islands. In accordance with the Federal Reserve Act, supervision and control of the Bank are exercised by a board of directors. Banks that are members of the System include all national banks and any state-chartered bank that applies and is approved for membership in the System.

Board of Directors

The Federal Reserve Act specifies the composition of the board of directors for each of the Reserve Banks. Each board is composed of nine members serving three-year terms: three directors, including those designated as Chairman and Deputy Chairman, are appointed by the Board of Governors, and six directors are elected by member banks. Of the six elected by member banks, three represent the public and three represent member banks. Member banks are divided into three classes according to size. Member banks in each class elect one director representing member banks and one representing the public. In any election of directors, each member bank receives one vote, regardless of the number of shares of Reserve Bank stock it holds.

2. OPERATIONS AND SERVICES

The System performs a variety of services and operations. Functions include: formulating and conducting monetary policy; participating actively in the payments mechanism, including large-dollar transfers of funds, automated clearinghouse operations, and check processing; distribution of coin and currency; fiscal agency functions for the U.S. Treasury and certain federal agencies; serving as the federal government's bank; providing short-term loans to depository institutions; serving the consumer and the community by providing educational materials and information regarding consumer laws; supervising bank holding companies, state member banks, and U.S. offices of foreign banking organizations; and administering other regulations of the Board of Governors. The Board of Governors' operating costs are funded through assessments on the Reserve Banks.

The FOMC establishes policy regarding open market operations, oversees these operations, and issues authorizations and directives to the Bank for its execution of transactions. Authorized transaction types include direct purchase and sale of securities, matched sale-purchase transactions, the purchase of securities under agreements to resell, and the lending of U.S. government securities. Additionally, the Bank is authorized by the FOMC to hold balances of, and to execute spot and forward foreign exchange and securities contracts in, fourteen foreign currencies; maintain reciprocal currency arrangements ("FX swaps") with various central banks; and "warehouse" foreign currencies for the U.S. Treasury Exchange Stabilization Fund ("ESF") through the Reserve Banks.

3. SIGNIFICANT ACCOUNTING POLICIES

Accounting principles for entities with the unique powers and responsibilities of the nation's central bank have not been formulated by the Financial Accounting Standards Board. The Board of Governors has developed specialized accounting principles and practices that it believes are appropriate for the significantly different nature and function of a central bank as compared to the private sector. These accounting principles and practices are documented in the "Financial Accounting Manual for Federal Reserve Banks" ("Financial Accounting Manual"), which is issued by the Board of Governors. All Reserve Banks are required to adopt and apply accounting policies and practices that are consistent with the Financial Accounting Manual.

The financial statements have been prepared in accordance with the Financial Accounting Manual. Differences exist between the accounting principles and practices of the System and generally accepted accounting principles ("GAAP").

The primary differences are the presentation of all security holdings at amortized cost, rather than at the fair value presentation requirements of GAAP, and the accounting for matched sale-purchase transactions as separate sales and purchases, rather than secured borrowings with pledged collateral, as is required by GAAP. In addition, the Bank has elected not to include a Statement of Cash Flows, as the liquidity and cash position of the Bank are not of primary concern to users of these financial statements. Other information regarding the Bank's activities is provided in, or may be derived from, the Statements of Condition, Income, and Changes in Capital. Therefore, a Statement of Cash Flows would not provide any additional useful information. There are no other significant differences between the policies outlined in the Financial Accounting Manual and GAAP.

The preparation of the financial statements in conformity with the Financial Accounting Manual requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates. Unique accounts and significant accounting policies are explained below.

a. Gold Certificates

The Secretary of the Treasury is authorized to issue gold certificates to the Reserve Banks to monetize gold held by the U.S. Treasury. Payment for the gold certificates by the Reserve Banks is made by crediting equivalent amounts in dollars into the account established for the U.S. Treasury. These gold certificates held by the Reserve Banks are required to be backed by the gold of the U.S. Treasury. The U.S. Treasury may reacquire the gold certificates at any time and the Reserve Banks must deliver them to the U.S. Treasury. At such time, the U.S. Treasury's account is charged and the Reserve Banks' gold certificate accounts are lowered. The value of gold for purposes of backing the gold certificates is set by law at $42 2/9 a fine troy ounce. The Board of Governors allocates the gold certificates among Reserve Banks once a year based upon Federal Reserve notes outstanding in each District at the end of the preceding year.

b. Special Drawing Rights Certificates

Special drawing rights ("SDRs") are issued by the International Monetary Fund ("Fund") to its members in proportion to each member's quota in the Fund at the time of issuance. SDRs serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law

providing for United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates, somewhat like gold certificates, to the Reserve Banks. At such time, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks' SDR certificate accounts are increased. The Reserve Banks are required to purchase SDRs, at the direction of the U.S. Treasury, for the purpose of financing SDR certificate acquisitions or for financing exchange stabilization operations. The Board of Governors allocates each SDR transaction among Reserve Banks based upon Federal Reserve notes outstanding in each District at the end of the preceding year.

c. Loans to Depository Institutions

The Depository Institutions Deregulation and Monetary Control Act of 1980 provides that all depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in Regulation D issued by the Board of Governors, have borrowing privileges at the discretion of the Reserve Banks. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. Loans are evaluated for collectibility, and currently all are considered collectible and fully collateralized. If any loans were deemed to be uncollectible, an appropriate reserve would be established. Interest is recorded on the accrual basis and is charged at the applicable discount rate established at least every fourteen days by the boards of directors of the Reserve Banks, subject to review by the Board of Governors. However, Reserve Banks retain the option to impose a surcharge above the basic rate in certain circumstances.

d. U.S. Government and Federal Agency Securities and Investments Denominated in Foreign Currencies

The Bank has been designated by the FOMC to execute open market transactions on its behalf and to hold the resulting securities in the portfolio known as the System Open Market Account ("SOMA"). In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes and directs the Bank to execute operations in foreign markets for major currencies in order to counter disorderly conditions in exchange markets or to meet other needs specified by the FOMC in carrying out the System's central bank responsibilities.

Purchases of securities under agreements to resell and matched sale-purchase transactions are accounted for as separate sale and purchase transactions. Purchases under agreements to resell are transactions in which the Bank purchases a security and sells it back at the rate specified at the commencement of the transaction. Matched sale-

purchase transactions are transactions in which the Bank sells a security and buys it back at the rate specified at the commencement of the transaction.

Reserve Banks are authorized by the FOMC to lend U.S. government securities held in the SOMA to U.S. government securities dealers and to banks participating in U.S. government securities clearing arrangements, in order to facilitate the effective functioning of the domestic securities market. These securities-lending transactions are fully collateralized by other U.S. government securities. FOMC policy requires the lending Reserve Bank to take possession of collateral in amounts in excess of the market values of the securities loaned. The market values of the collateral and the securities loaned are monitored by the lending Reserve Bank on a daily basis, with additional collateral obtained as necessary. The securities loaned continue to be accounted for in the SOMA.

Foreign exchange contracts are contractual agreements between two parties to exchange specified currencies at a specified price on a specified date. Spot foreign contracts normally settle two days after the trade date, whereas the settlement date on forward contracts extends beyond two days from the trade date. The Bank generally enters into spot contracts, with any forward contracts generally limited to the second leg of a swap/warehousing transaction.

The Bank, on behalf of the Reserve Banks, maintains renewable, short-term FX swap arrangements with authorized foreign central banks. The parties agree to exchange their currencies up to a prearranged maximum amount and for an agreed-upon period of time (up to twelve months) at an agreed-upon interest rate. These arrangements give the FOMC temporary access to foreign currencies that it may need for intervention operations to support the dollar and give the partner foreign central bank temporary access to dollars it may need to support its own currency. Drawings under the FX swap arrangements can be initiated by either the Bank or the partner foreign central bank, and must be agreed to by the drawee. The FX swaps are structured so that the party initiating the transaction (the drawer) bears the exchange rate risk upon maturity. The Bank will generally invest the foreign currency received under an FX swap in interest-bearing instruments.

Warehousing is an arrangement under which the FOMC agrees to exchange, at the request of the Treasury, U.S. dollars for foreign currencies held by the Treasury or ESF over a limited period of time. The purpose of the warehousing facility is to supplement the U.S. dollar resources of the Treasury and ESF for financing purchases of foreign currencies and related international operations.

In connection with its foreign currency activities, the Bank, on behalf of the Reserve Banks, may enter into contracts that contain varying degrees of off-balance-sheet market risk, because they represent contractual commitments involving future settlement, and counterparty credit risk. The Bank controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

While the application of current market prices to the securities currently held in the SOMA portfolio and investments denominated in foreign currencies may result in values substantially above or below their carrying values, these unrealized changes in value would have no direct effect on the quantity of reserves available to the banking system or on the prospects for future Reserve Bank earnings or capital. Both the domestic and foreign components of the SOMA portfolio from time to time involve transactions that can result in gains or losses when holdings are sold prior to maturity. However, decisions regarding the securities and foreign currency transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, earnings and any gains or losses resulting from the sale of such currencies and securities are incidental to the open market operations and do not motivate its activities or policy decisions.

U.S. government and federal agency securities and investments denominated in foreign currencies comprising the SOMA are recorded at cost, on a settlement-date basis, and adjusted for amortization of premiums or accretion of discounts on a straight-line basis. Interest income is accrued on a straight-line basis and is reported as "Interest on U.S. government securities" or "Interest on foreign currencies," as appropriate. Income earned on securities-lending transactions is reported as a component of "Other income." Gains and losses resulting from sales of securities are determined by specific issues based on average cost. Gains and losses on the sales of U.S. government and federal agency securities are reported as "Government securities gains, net." Foreign-currency-denominated assets are revalued monthly at current market exchange rates in order to report these assets in U.S. dollars. Realized and unrealized gains and losses on investments denominated in foreign currencies are reported as "Foreign currency (losses), net." Foreign currencies held through FX swaps, when initiated by the counterparty, and warehousing arrangements are revalued monthly, with the unrealized gain or loss reported by the Bank as a component of "Other assets" or "Other liabilities," as appropriate.

Balances of U.S. government and federal agency securities bought outright, investments denominated in foreign currency, interest income, amortization of

premiums and discounts on securities bought outright, gains and losses on sales of securities, and realized and unrealized gains and losses on investments denominated in foreign currencies, excluding those held under an FX swap arrangement, are allocated to each Reserve Bank. Securities purchased under agreements to resell and the related premiums, discounts, and income, and unrealized gains and losses on the revaluation of foreign currency holdings under FX swaps and warehousing arrangements are designated to the Bank and not participated to other Reserve Banks. Income from securities-lending transactions is recognized only by the lending Reserve Bank.

e. Bank Premises and Equipment

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over estimated useful lives of assets ranging from two to fifty years. New assets, major alterations, renovations, and improvements are capitalized at cost as additions to the asset accounts. Maintenance, repairs, and minor replacements are charged to operations in the year incurred.

f. Interdistrict Settlement Account

At the close of business each day, all Reserve Banks and branches assemble the payments due to or from other Reserve Banks and branches as a result of transactions involving accounts residing in other Districts that occurred during the day's operations. Such transactions may include funds settlement, check clearing and automated clearinghouse ("ACH") operations, and allocations of shared expenses. The cumulative net amount due to or from other Reserve Banks is reported as the "Interdistrict settlement account."

g. Federal Reserve Notes

Federal Reserve notes are the circulating currency of the United States. These notes are issued through the various Federal Reserve Agents to the Reserve Banks upon deposit with such Agents of certain classes of collateral security, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve Agent must be equal to the sum of the notes applied for by such Reserve Bank. In accordance with the Federal Reserve Act, gold certificates, special drawing rights certificates, U.S. government and agency securities, loans allowed under Section 13, and investments denominated in foreign currencies are pledged as collateral for net Federal Reserve notes outstanding. The collateral value is equal to the book value of the collateral tendered, with the

exception of securities, whose collateral value is equal to the par value of the securities tendered. The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately collateralize the Federal Reserve notes. To satisfy their obligation to provide sufficient collateral for their outstanding Federal Reserve notes, the Reserve Banks have entered into an agreement that provides that certain assets of the Reserve Banks are jointly pledged as collateral for the Federal Reserve notes of all Reserve Banks. In the event that this collateral is insufficient, the Federal Reserve Act provides that Federal Reserve notes become a first and paramount lien on all the assets of the Reserve Banks. Finally, as obligations of the United States, Federal Reserve notes are backed by the full faith and credit of the United States government.

The "Federal Reserve notes outstanding, net" account represents Federal Reserve notes reduced by cash held in the vaults of the Bank of $30,527 million and $44,004 million at December 31, 1997, and December 31, 1996, respectively.

h. Capital Paid-in

The Federal Reserve Act requires that each member bank subscribe to the capital stock of the Reserve Bank in an amount equal to 6 percent of the capital and surplus of the member bank. As a member bank's capital and surplus change, its holdings of the Reserve Bank's stock must be adjusted. Member banks are those state-chartered banks that apply and are approved for membership in the System and all national banks. Currently, only one-half of the subscription is paid-in and the remainder is subject to call. These shares are nonvoting, with a par value of $100. They may not be transferred or hypothecated. By law, each member bank is entitled to receive an annual dividend of 6 percent on the paid-in capital stock. This cumulative dividend is paid semiannually. A member bank is liable for Reserve Bank liabilities up to twice the par value of stock subscribed by it.

i. Surplus

The Board of Governors requires Reserve Banks to maintain a surplus equal to the amount of capital paid-in as of December 31 of the prior year. This amount is intended to provide additional capital and reduce the possibility that the Reserve Banks would be required to call on member banks for additional capital. Reserve Banks are required by the Board of Governors to transfer to the U.S. Treasury excess earnings, after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in. Prior to October 1, 1996, this payment represented payment of interest on Federal Reserve notes outstanding.

The Omnibus Budget Reconciliation Act of 1993 (Public Law 103-66, Section 3002) codified the existing Board surplus policies as statutory surplus transfers, rather than as payments of interest on Federal Reserve notes, for federal government fiscal years 1998 and 1997 (which began on October 1, 1997, and October 1, 1996, respectively). In addition, the legislation directed the Reserve Banks to transfer to the U.S. Treasury additional surplus funds of $107 million and $106 million during fiscal years 1998 and 1997, respectively. Reserve Banks are not permitted to replenish surplus for these amounts during this time. The Reserve Banks made these transfers on October 1, 1997, and October 1, 1996, respectively. The Bank's share of these transfers is reported on the Statement of Changes in Capital as "Statutory surplus transfer to the U.S. Treasury."

In the event of losses, payments to the U.S. Treasury are suspended until such losses are recovered through subsequent earnings. Weekly payments to the U.S. Treasury vary significantly.

j. Cost of Unreimbursed Treasury Services

The Bank is required by the Federal Reserve Act to serve as fiscal agent and depository of the United States. By statute, the Department of the Treasury is permitted, but not required, to pay for these services. The costs of providing fiscal agency and depository services to the Treasury Department that have been billed but will not be paid are reported as the "Cost of unreimbursed Treasury services."

k. Taxes

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property, which are reported as a component of "Occupancy expense."

4. U.S. GOVERNMENT AND FEDERAL AGENCY SECURITIES

Securities bought outright and held under agreements to resell are held in the SOMA at the Bank. An undivided interest in SOMA activity, with the exception of securities held under agreements to resell and the related premiums, discounts, and income, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of interdistrict clearings. The settlement, performed in April of each year, equalizes Reserve Bank gold certificate holdings to Federal Reserve notes outstanding. The Bank's allocated share of SOMA balances was approximately 32.345 percent and 37.190 percent at December 31, 1997, and December 31, 1996, respectively.

The Bank's allocated shares of securities held in the SOMA at December 31, 1997, and December 31, 1996, that were bought outright were as follows:

	Amount (in Millions)	
	1997	1996
Par value:		
Federal agency	$ 221	$ 827
U.S. government:		
Bills	63,760	70,901
Notes	56,347	56,127
Bonds	19,215	18,349
Total par value	139,543	146,204
Unamortized premiums	2,005	1,739
Unaccreted discounts	(1,170)	(1,319)
Total allocated to Bank	**$140,378**	**$146,624**

Total SOMA securities bought outright were $434,001 million and $394,261 million at December 31, 1997, and December 31, 1996, respectively.

The maturities of U.S. government and federal agency securities bought outright, which were allocated to the Bank at December 31, 1997, were as follows:

	Par Value (in Millions)		
Maturities of Securities Held	U.S. Government Securities	Federal Agency Obligations	Total
Within 15 days	$ 4,192	$ —	$ 4,192
16 days to 90 days	30,937	19	30,956
91 days to 1 year	44,599	62	44,661
Over 1 year to 5 years	30,737	50	30,787
Over 5 years to 10 years	13,231	82	13,313
Over 10 years	15,626	8	15,634
Total	**$139,322**	**$221**	**$139,543**

Securities held under agreements to resell at December 31, 1997, and December 31, 1996, were as follows:

	Amount (in Millions)	
	1997	1996
Par value:		
Federal agency	$ 2,652	$ 1,612
U.S. government	21,188	19,971
Total par value	23,840	21,583
Unamortized premiums	996	1,327
Unaccreted discounts	(282)	(296)
Total	**$24,554**	**$22,614**

These balances have been allocated solely to the Bank. The resell date for securities under agreements to resell does not exceed fifteen days after the purchase date.

At December 31, 1997, and December 31, 1996, matched sale-purchase transactions involving U.S. government securities with par values of $17 billion and $15 billion, respectively, were outstanding, of which $6 billion and $5 billion were allocated to the Bank. Matched sale-purchase transactions are generally overnight arrangements.

At December 31, 1997, and December 31, 1996, U.S. government securities with par values of $887 million and $489 million, respectively, were loaned by the Bank.

5. INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES

The Bank, on behalf of the Reserve Banks, holds foreign currency deposits with foreign central banks and the Bank for International Settlements and invests in foreign government debt instruments. Foreign government debt instruments held include both securities bought outright and securities held under agreements to resell. These investments are guaranteed as to principal and interest by the foreign governments.

Each Reserve Bank is allocated a share of foreign-currency-denominated assets, the related interest income, and realized and unrealized foreign currency gains and losses, with the exception of unrealized gains and losses on FX swaps and

warehousing transactions. This allocation is based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31. The Bank's allocated share of investments denominated in foreign currencies was approximately 22.804 percent and 26.639 percent at December 31, 1997, and December 31, 1996, respectively.

The Bank's allocated shares of investments denominated in foreign currencies, valued at current exchange rates at December 31, 1997, and December 31, 1996, were as follows:

	Amount (in Millions)	
	1997	1996
German marks:		
Foreign currency deposits	$1,886	$2,731
Government debt instruments including agreements to resell	733	740
Japanese yen:		
Foreign currency deposits	131	170
Government debt instruments including agreements to resell	1,118	1,469
Accrued interest	17	18
Total	**$3,885**	**$5,128**

Total investments denominated in foreign currencies were $17,046 million and $19,264 million at December 31, 1997, and December 31, 1996, respectively. The December 31, 1997, and December 31, 1996, balances include $3 million and $5 million, respectively, of unearned interest collected on certain foreign currency holdings that are allocated solely to the Bank and are included in accrued interest above.

The maturities of investments denominated in foreign currencies that were allocated to the Bank at December 31, 1997, and December 31, 1996, were as follows:

Maturities of Investments Denominated in Foreign Currencies	Amount (in Millions) 1997	1996
Within 1 year	$3,821	$5,128
Over 1 year to 5 years	16	—
Over 5 years to 10 years	48	—
Over 10 years	—	—
Total	$3,885	$5,128

At December 31, 1997, and December 31, 1996, the Bank had no open foreign exchange contracts. At December 31, 1997, and December 31, 1996, there were no FX swaps outstanding. At December 31, 1997, and December 31, 1996, the warehousing facility was $20 billion, with zero outstanding.

6. BANK PREMISES AND EQUIPMENT

A summary of bank premises and equipment at December 31, 1997, and December 31, 1996, is as follows:

	Amount (in Millions) 1997	1996
Bank premises and equipment:		
Land	$ 21	$ 21
Buildings	135	119
Building machinery and equipment	48	51
Construction in progress	2	7
Furniture and equipment	221	212
Subtotal	427	410
Accumulated depreciation	(186)	(177)
Bank premises and equipment, net	$241	$233

Note: Depreciation expenses were $32 million and $30 million for the years ended December 31, 1997, and December 31, 1996, respectively.

Bank premises and equipment at December 31, 1997, and December 31, 1996, include the following amounts for leases that have been capitalized:

	Amount (in Millions)	
	1997	1996
Bank premises and equipment	$15	$15
Accumulated depreciation	(14)	(10)
Capitalized leases, net	**$ 1**	**$ 5**

7. COMMITMENTS AND CONTINGENCIES

At December 31, 1997, the Bank was obligated under noncancelable leases for premises and equipment with terms ranging from one to approximately twenty-six years. These leases provide for increased rentals based upon increases in real estate taxes, operating costs, or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance, and maintenance when included in rent), net of sublease rentals, was $18 million for each of the years ended December 31, 1997, and December 31, 1996. Certain of the Bank's leases have options to renew.

Future minimum rental payments under noncancelable operating leases, net of sublease rentals and concessions, with terms of one year or more, at December 31, 1997, were:

	Amount (in Millions)
1998	$ 4.0
1999	5.0
2000	5.2
2001	4.6
2002	4.4
Thereafter	122.9
	$146.1

At December 31, 1997, there were no other commitments and long-term obligations in excess of one year.

Under the Insurance Agreement of the Federal Reserve Banks dated June 7, 1994, each of the Reserve Banks has agreed to bear, on a per incident basis, a pro rata share of losses in excess of 1 percent of the capital of the claiming Reserve Bank, up to 50 percent of the total capital and surplus of all Reserve Banks. Losses are borne in the ratio that a Reserve Bank's capital bears to the total capital of all Reserve Banks at the beginning of the calendar year in which the loss is shared. No claims were outstanding under such agreement at December 31, 1997, or December 31, 1996.

The Bank is involved in certain legal actions and claims arising in the ordinary course of business. Although it is difficult to predict the ultimate outcome of these actions, in management's opinion, based on discussions with counsel, the aforementioned litigation and claims will be resolved without material adverse effect on the financial position or results of operations of the Bank.

8. RETIREMENT AND THRIFT PLANS

Retirement Plans

The Bank currently offers two defined benefit retirement plans to its employees, based on length of service and level of compensation. Substantially all of the Bank's employees participate in the Retirement Plan for Employees of the Federal Reserve System ("System Plan") and the Benefit Equalization Retirement Plan ("BEP").

The System Plan is a multi-employer plan. The Bank acts as the sponsor of this plan, including the prepaid pension cost as a component of "Other assets." The prepaid pension cost includes amounts related to the participation of employees of the twelve Reserve Banks, the Board of Governors, and the Plan Administrative Office in the plan.

Contributions to the System Plan are actuarially determined and fully funded by participating employers at amounts prescribed by the Plan Administrator (with the exception of a mandatory contribution of 7 percent of salary by certain employees of the Board of Governors that participate in the plan). No separate accounting is maintained of assets contributed by the participating employers. It is the System's policy to fund the pension liability as accrued. No contributions to the System Plan were required under this policy during 1997 or 1996.

The BEP is an unfunded plan that was established January 1, 1996. Net pension cost for the period is actuarially determined and is based on the same economic and mortality assumptions used for the System Plan. The Bank's projected benefit obligation and net pension costs for the BEP at December 31, 1997, and December 31, 1996, and for the years then ended, are not material and are reflected as components of "Accrued benefit cost" and "Salaries and other benefits," respectively.

Following is a reconciliation between the funded status of the System Plan and amounts recognized at December 31, 1997, and December 31, 1996:

	Amount (in Millions)	
	1997	1996
Accumulated benefit obligation:		
Vested	$1,931	$1,758
Nonvested	90	85
Total	**$2,021**	**$1,843**
Plan assets at fair value, primarily listed stocks and bonds	5,031	4,153
Less: Actuarial present value of projected benefit obligation	2,476	2,270
Plan assets in excess of projected benefit obligation	2,555	1,883
Less: Unrecognized net transition obligation	181	226
Unrecognized net gain	1,307	884
Unrecognized prior service cost	(135)	(144)
Prepaid pension cost	$1,202	$ 917

The assumptions used in developing the pension benefit obligation for the System Plan and BEP are as follows:

	1997	1996
Discount rate	7.00%	7.25%
Rate of compensation increase	5.00%	5.00%
Long-term rate of return on plan assets	9.00%	9.00%

The components of the net pension credit for the System Plan for the years ended December 31, 1997, and December 31, 1996, are shown below:

	Amount (in Millions)	
	1997	1996
Service cost—benefits earned during the year	$ 71	$ 71
Interest cost on projected benefit obligation	160	152
Actual return on plan assets	(904)	(634)
Net amortization and deferral	468	269
Cost of special termination benefits	4	1
Net pension (credit)	**$(201)**	**$(141)**

Note: The net pension credit is reported as "Net periodic pension credit."

Thrift Plan

Employees of the Bank may also participate in the Thrift Plan for Employees of the Federal Reserve System ("Thrift Plan"). The Thrift Plan is a defined contribution plan. Under the Thrift Plan, employees may contribute a percentage of their salaries up to a maximum 20 percent limit. Matching contributions by the Bank are based on a fixed percentage of each employee's basic contribution. Currently, the Bank matches 80 percent of the first 6 percent of salary contributed by the employee. The Bank's Thrift Plan contributions totaled $9 million for each of the years ended December 31, 1997, and December 31, 1996, and are reported as a component of "Salaries and other benefits."

9. POSTRETIREMENT BENEFITS OTHER THAN PENSIONS AND POSTEMPLOYMENT BENEFITS

Postretirement Benefits Other Than Pensions

In addition to the Bank's defined benefit retirement plans, employees who have met certain age and length of service requirements are eligible for both medical benefits and life insurance coverage during retirement. The retiree medical plan is contributory and provides benefits to retirees, their covered dependents, and beneficiaries. The life insurance plan is noncontributory and covers retirees only.

The Bank funds benefits payable under the medical and life insurance plans as due. Net postretirement benefit cost is actuarially determined, using a January 1 measurement date.

The following is a reconciliation between the plan's funded status and the amounts recognized as of December 31, 1997, and December 31, 1996:

	Amount (in Millions)	
	1997	1996
Accumulated postretirement benefit obligation:		
Retirees and covered spouses	$ 75	$ 62
Actives eligible to retire	8	12
Other actives and disableds	38	44
Total accumulated postretirement benefit obligation	**121**	**118**
Unrecognized net gain (loss)	5	4
Unrecognized prior service cost	1	1
Accrued postretirement benefit cost	**$127**	**$123**

Note: Accrued postretirement benefit cost is reported as a component of "Accrued benefit cost."

The assumptions used in developing the postretirement benefit obligation are as follows:

	1997	1996
Discount rate	7.00%	7.25%
Rate of increase in health care costs—initial	9.00%	9.50%
Rate of increase in health care costs—ultimate	5.00%	5.50%

Note: The ultimate health care cost rate is expected to be achieved in 2005.

The following is a summary of the components of net periodic postretirement cost for the years ended December 31, 1997, and December 31, 1996:

	Amount (in Millions)	
	1997	1996
Service cost	$ 3	$ 3
Interest cost of accumulated benefit obligation	8	8
Net amortization and deferral	0	0
Net periodic postretirement cost	**$11**	**$11**

Note: Net periodic postretirement cost is reported as a component of "Salaries and other benefits."

Changing the assumed health care cost trend rates by one percentage point in each year would change the accumulated postretirement benefit obligation at December 31, 1997, and December 31, 1996, by approximately $18 million and $21 million, respectively, and would change the aggregate service and interest cost components of net periodic postretirement benefit cost for the years ended December 31, 1997, and December 31, 1996, by approximately $3 million in each year.

Postemployment Benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined and include the cost of medical and dental insurance, survivor income, and disability benefits. Costs were projected using the same discount rate and health care trend rates as were used for projecting postretirement costs. The accrued postemployment benefit costs recognized by the Bank at December 31, 1997, and December 31, 1996, were $16 million and $14 million, respectively. This cost is included as a component of "Accrued benefit cost." Net periodic postemployment benefit costs included in 1997 and 1996 operating expenses were $4 million in each year.

Directors of the Federal Reserve Bank of New York

CHANGES IN DIRECTORS
1998

Member banks in this District elected WALTER V. SHIPLEY a class A director of this Bank for a three-year term beginning January 1998. Mr. Shipley is Chairman and Chief Executive Officer of The Chase Manhattan Corporation and The Chase Manhattan Bank, New York, N.Y. Mr. Shipley succeeds J. Carter Bacot, Chairman and Chief Executive Officer of The Bank of New York, New York, N.Y., who served as a class A director since January 1995.

Member banks in this District reelected EUGENE R. McGRATH a class B director of this Bank for a three-year term beginning January 1998. Mr. McGrath, who is Chairman, President, and Chief Executive Officer of Consolidated Edison Company of New York, Inc., New York, N.Y., has been serving as a class B director since January 1995.

The Board of Governors of the Federal Reserve System redesignated JOHN C. WHITEHEAD Chairman of the Board and Federal Reserve Agent for the year 1998. Mr. Whitehead, who is a former chairman of Goldman, Sachs & Co., Inc., New York, N.Y., has been serving as a class C director since September 1995 and as Chairman and Federal Reserve Agent since January 1996.

The Board of Governors also reappointed THOMAS W. JONES a class C director of this Bank for a three-year term beginning January 1998 and redesignated him Deputy Chairman for the year 1998. Mr. Jones, who is Vice Chairman of Travelers Group and Chairman and Chief Executive Officer of Smith Barney Asset Management, New York, N.Y., has been serving as a class C director and Deputy Chairman since January 1996.

BUFFALO BRANCH

The Board of Governors reappointed LOUIS J. THOMAS a director of the Buffalo Branch for a three-year term beginning January 1998. Mr. Thomas, who is Director, District 4, of the United Steelworkers of America, Cheektowaga, N.Y., has been a director of the Branch since January 1996.

The Board of Directors of this Bank reappointed MARK W. ADAMS a director of the Buffalo Branch for a three-year term beginning January 1998. Mr. Adams, who is the Operator of Adams Poultry Farm, Naples, N.Y., has been a director of the Buffalo Branch since January 1995.

The Board of Directors of this Bank also reappointed WILLIAM E. SWAN a director of the Buffalo Branch for a three-year term beginning January 1998. Mr. Swan, who is President and Chief Executive Officer of Lockport Savings Bank, Lockport, N.Y., has been serving as a Branch director since January 1995.

The Board of Directors of this Bank redesignated BAL DIXIT Chairman of the Board of the Buffalo Branch for the year 1998. Mr. Dixit, who is President and Chief Executive Officer of Newtex Industries, Inc., Victor, N.Y., has been serving as a director of the Branch since January 1996, and as Chairman of the Branch Board since January 1997.

DIRECTORS OF THE FEDERAL RESERVE BANK OF NEW YORK

DIRECTORS	TERM EXPIRES DEC. 31	CLASS
J. CARTER BACOT *Chairman and Chief Executive Officer* The Bank of New York, New York, N.Y.	1997	A
ROBERT G. WILMERS *Chairman and Chief Executive Officer* Manufacturers and Traders Trust Company, and *Chairman, President, and Chief Executive Officer* First Empire State Corporation, Buffalo, N.Y.	1998	A
GEORGE W. HAMLIN, IV *President and Chief Executive Officer* The Canandaigua National Bank and Trust Company, Canandaigua, N.Y.	1999	A
EUGENE R. McGRATH *Chairman, President, and Chief Executive Officer* Consolidated Edison Company of New York, Inc., New York, N.Y.	1997	B
VACANCY	1998	B
ANN M. FUDGE *Executive Vice President* Kraft Foods, Inc., and *President* Coffee & Cereals Division, Tarrytown, N.Y.	1999	B
THOMAS W. JONES, Deputy Chairman *Vice Chairman* Travelers Group, and *Chairman and Chief Executive Officer* Smith Barney Asset Management, New York, N.Y.	1997	C
PETER G. PETERSON *Chairman* The Blackstone Group, New York, N.Y.	1998	C
JOHN C. WHITEHEAD, Chairman and Federal Reserve Agent *Former Chairman* Goldman, Sachs & Co., Inc., New York, N.Y.	1999	C

DIRECTORS	TERM EXPIRES DEC. 31
Buffalo Branch	
BAL DIXIT, Chairman *President and Chief Executive Officer* Newtex Industries, Inc., Victor, N.Y.	1998
MARK W. ADAMS *Operator* Adams Poultry Farm, Naples, N.Y.	1997
WILLIAM E. SWAN *President and Chief Executive Officer* Lockport Savings Bank, Lockport, N.Y.	1997
LOUIS J. THOMAS *Director, District 4* United Steelworkers of America, Cheektowaga, N.Y.	1997
KATHLEEN R. WHELEHAN *Regional President, Rochester Southern Region* Marine Midland Bank, Rochester, N.Y.	1998
PATRICK P. LEE *Chairman and Chief Executive Officer* International Motion Control, Inc., Orchard Park, N.Y.	1999
LOUISE WOERNER *Chairman and Chief Executive Officer* HCR, Rochester, N.Y.	1999

Advisory Groups

ADVISORY GROUPS

FEDERAL ADVISORY COUNCIL

Second District Member

DOUGLAS A. WARNER III
Chairman, President, and Chief Executive Officer
J.P. Morgan & Co. Incorporated, New York, N.Y.

Alternate Member

MICHAEL E. PATTERSON
Vice Chairman
J.P. Morgan & Co. Incorporated, New York, N.Y.

ECONOMIC ADVISORY PANEL

JAMES ANNABLE
First National Bank of Chicago

BEN S. BERNANKE
Princeton University

RUDIGER W. DORNBUSCH
Massachusetts Institute of Technology

MARTIN S. FELDSTEIN
Harvard University

BENJAMIN M. FRIEDMAN
Harvard University

GLENN HUBBARD
Columbia University

PETER B. KENEN
Princeton University

MICKEY LEVY
NationsBanc Capital Markets Inc.

FREDERIC MISHKIN
Columbia University

WILLIAM POOLE
Brown University

ROBERT J. SHILLER
Yale University

WILLIAM L. SILBER
New York University

JOHN TAYLOR
Stanford University

ADVISORY COUNCIL ON SMALL BUSINESS AND AGRICULTURE

Chairman

BARBARA B. ROBERTS
President
Roberts & Company, New York, N.Y.

JOEL CARTUN
President and Chief Executive Officer
Vestcom International Inc., Lyndhurst, N.J.

PETER D. HANKS
Big Green Farms, Salem, N.Y.

JOHN W. LINCOLN
President
Linholm Farm, Bloomfield, N.Y.

JAMES I. NIXON
Stamford, Conn.

LORI NORTHRUP
President
Stride Tool, Inc., Ellicottville, N.Y.

PETER POWERS
President and Chief Executive Officer
Clearplass Containers, Inc., Penn Yan, N.Y.

MARGARET ROWLETT
President
A-1 Resources, Providence, N.J.

MARTIN SILVER
President and Chief Executive Officer
Northeast Wood Crafts, Inc., Amsterdam, N.Y.

INTERNATIONAL CAPITAL MARKETS ADVISORY COMMITTEE

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Chairman of the Board
Swiss Bank Corporation
Basle, Switzerland

EMILIO BOTIN
President
Banco Santander, S.A.
Santander, Spain

WILLIAM J. BRODSKY
Chairman and Chief Executive Officer
Chicago Board Options Exchange
Chicago, Ill.

MATHIS CABIALLAVETTA
President of the Group Executive Board
Union Bank of Switzerland
Zurich, Switzerland

DR. ULRICH CARTELLIERI
Member of the Supervisory Board
Deutsche Bank AG
Frankfurt, Germany

JON S. CORZINE
Chairman and Chief Executive Officer
Goldman, Sachs & Co., Inc.
New York, N.Y.

DAVID A. COULTER
Chairman and Chief Executive Officer
BankAmerica Corporation
San Francisco, Calif.

BRUCE C. GALLOWAY
Vice Chairman
Royal Bank of Canada
Toronto, Canada

RICHARD A. GRASSO
Chairman and Chief Executive Officer
New York Stock Exchange, Inc.
New York, N.Y.

ING. RICARDO GUAJARDO TOUCHE
Chief Executive Officer
Bancomer, S.A.
Mexico City, Mexico

GERD HAUSLER
Member of the Board of Managing Directors
Dresdner Bank Aktiengesellschaft
Frankfurt, Germany

JOHN G. HEIMANN
Chairman, Global Financial Institutions
Merrill Lynch & Co., Inc.
New York, N.Y.

P. JAN KALFF
Chairman of the Managing Board
ABN AMRO Bank N.V.
Amsterdam, the Netherlands

HENRY KAUFMAN
President
Henry Kaufman & Company, Inc.
New York, N.Y.

YOH KUROSAWA
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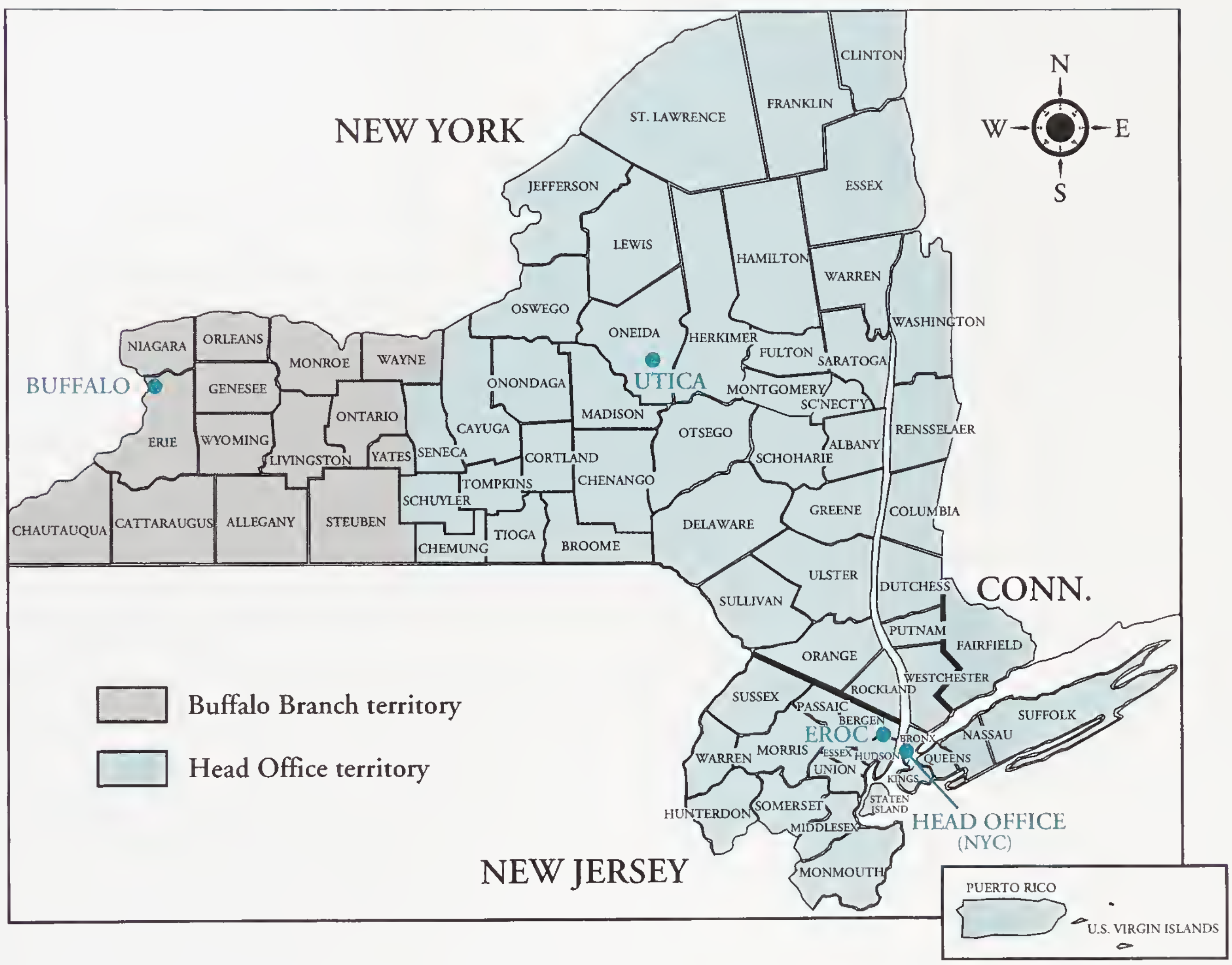
Map of the Second Federal Reserve District

THE SECOND FEDERAL RESERVE DISTRICT



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